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TAGS: ECON EFIN EINV PGOV TU
SUBJECT: THE NEW GOVERNMENT'S ECONOMIC CHALLENGES, AND SOME BENCHMARKS

¶1. (SBU) Summary: The new Turkish Government's most pressing economic challenge is to bolster market confidence sufficiently to avoid another financial crisis and begin to step away from the financial precipice on which Turkey has been perched for the past two years. Other challenges include: reducing inflation, maintaining growth through creation of a better investment environment, tax reform, and a stronger banking sector; promoting a new business model based on competitiveness and sound corporate governance; and beginning to address the country's poverty. Dealing with a potential external shock would of course be another challenge, but it would not fundamentally change the economic steps Turkey needs to take. We have identified several near and medium-term benchmarks for gauging the new government's economic performance. End Summary.

Economic Challenges

¶2. (SBU) The incoming government's most important and urgent economic challenge will be to obtain sufficient financing, at reasonable rates, to meet its debt obligations in 2003, begin to reduce its debt/GNP ratio, and reduce its vulnerability to external or internal shocks. This will require maintaining a large primary budget surplus and bolstering market confidence sufficiently to (a) lower nominal interest rates to an average of 45-47 percent for the year, (b) convince domestic holders of t-bills to roll over more than 90 percent of the domestic debt, and (c) obtain substantially increased access to the Eurobond and private bank credit markets. If the government can do this, it should be able to reduce Turkey's sky-high debt/GNP ratio from the current 82-83 percent to some 78 percent by end-2003. Failure would probably mean another financial crisis. Progress, or at least the absence of negative developments, on Cyprus and EU accession would certainly help boost confidence.

¶3. (SBU) The government will face a host of other, related economic challenges. Two key ones are relatively short-term (i.e., need to be done next year):

-- Reducing inflation: The Central Bank now expects to achieve or surpass its 35 percent end-year inflation target for this year, but both the Bank and private analysts wonder if it can achieve next year's target of 20 percent. Defeating inflation -- meaning bringing it down to single digits -- is essential if Turkey is to have any chance of maintaining financial stability and generating the productive investment needed to enjoy sustained growth. Because expecations play such a huge role in determining inflation here, the government must maintain the current positive momentum by meeting its 2003 target.
This will require continuation of tight fiscal and monetary policy, avoidance of a sharp depreciation of the lira, continued structural reform to encourage competitive pricing, and a clear public message from the new government that it is committed to defeating inflation.

-- Maintaining growth: The country desperately needs solid growth to create jobs, maintain support for the reform program, and keep its debt sustainable. Although Turkey is likely to surpass its initial 3 percent GNP growth target for this year (probably reaching 4 or 4.5 percent), the recovery remains weak. Sustaining growth in 2003-2004 will require, in addition to macroeconomic stability, continued efforts to strengthen the banking sector (which is doing very little commercial lending), further tax reform, and improve the dismal investment environment. Foreign investment inflows

through the first eight months of this year totaled a pitiful $180 million, and anecdotal evidence indicates Turkish companies are equally unenthusiastic about investing.

¶4. (SBU) Two other challenges are longer-term (note: our list of challenges is not meant to be exhaustive):

-- Promoting a new business model: One of the fundamental weaknesses of the Turkish economy -- and a key contributor to the recent economic crisis -- is the reliance of much of the private sector on political patronage/favoritism rather than efficiency and competitiveness to make money. Although there are many solid businesses in Turkey, too many companies have made money for years through subsidized lending, politically-connected contracts, protection from competition, and -- in the case of agriculture -- guaranteed purchases by the State. The reforms of the past 18 months have made it much more difficult to do business this way, but corporate Turkey has just begun to change its mentality. The new government can facilitate this essential change in mentality (and practice) by making clear that it will not return to the old ways of doing business, by promoting a sound, pro-competition regulatory environment, by reducing the role of the State in the economy, and by publicly stressing the need for businesses to adapt to the "new rules of the game."

-- Begin to address poverty: Large segments of the Turkish population, particularly in the rural East and Southeast but also in the cities, remains impoverished. This is an issue of both regional disparity and of rural development. Defeating inflation and promoting growth are necessary but not sufficient to address this problem. There is no easy solution to the problem of underdevelopment, of course, but one area in which the new government might focus is promoting agricultural productivity. Currently, more than 40 percent of the Turkish population is engaged in farming, but they produce only 15 percent of GNP. This lack of productivity is a drag on the entire economy and a key contributor to poverty.

Benchmarks

¶5. (SBU) We have come up with a brief list of benchmarks to help us gauge the new government's efforts to meet these challenges, with particularly attention to steps the government could take to bolster market confidence.

Short-term (by end-2002)

-- Invite IMF back to complete the 4th review as quickly as possible.

-- Present 2003 budget that meets primary surplus target of 6.5 percent of GNP (and, as much as possible, ensure that necessary fiscal measures are taken in the coming weeks to ensure GOT meets this year's primary surplus target).

-- Move ahead with scheduled privatization of Petkim, strategic sale of part of Tupras, approve privatization plans for state sugar company, Tekel, Turk Telekom.

-- Pass direct tax reform legislation.

-- Reduce the number of ministries and state ministers.

Medium-term (2003)

-- Announce, at the senior political level, full support for the end-2003 20 percent inflation target.

-- Make clear through public statements as well as actions government's full support for independent regulatory boards (energy, banking, and telecom) as well as full independence of Central Bank. (This also means not taking steps -- as AK has indicated it might -- to weaken the bank regulatory board.)

-- Accelerate privatization, including by selling Erdemir (steel), Tekel, Turk Telekom (or parts of it), and sugar

companies.

-- Implement social security reform to prevent a major fiscal problem as retirements accelerate over the coming years.

-- Announce accelerated liberalization of fixed telecom services (now scheduled to be open to competition at end-2003), and grant licenses to companies in already-liberalized sectors such as GSM and local wireless services.

-- Appoint strong official to lead Capital Markets Board, and give that person a mandate to promote improved corporate governance and broadened capital markets.
-- Create public-private sector commission to develop national energy policy.

-- Resolve at least some of pending foreign investment problems, including Cargill, cola tax, long-pending energy contracts, and pharmaceutical-related IPR issues.

-- Either establish a true one-stop shop for foreign investment or appoint a senior official (preferably in the Prime Ministry's office) to resolve foreign investment-related problems.

-- Privatize the Istanbul Stock Exchange

-- Create a technical-level marketing advisory board to help farmers, who have long sold their crops to the state, shift toward selling to domestic and international markets.

-- Encourage development by private sector of business plans for Qualifying Industrial Zones, assuming U.S. Congress passes QIZ legislation.

Important First Steps

¶6. (SBU) The key right now is for AK Party, as it prepares to assume the reins of government, to build on the positive momentum resulting from its election victory (and the initial market reaction). If it reassures markets that it will follow sound economic policies, including taking some of the steps identified above, it will have a good chance of keeping interest rates on their downward track. The new government would then have significantly better prospects for achieving greater financial stability in 2003 and thus for addressing Turkey's many other economic challenges.
PEARSON